CHAPTER V

# MECHANISM OF INTERNATIONAL PAYMENTS: THEORY OF FOREIGN EXCHANGES

## I. What is Foreign Exchange?:-

The mechanism of payment in foreign trade is known as the foreign exchange. In foreign exchange we deal not with goods but the value of goods expressed in most cases by credit ~~instalments~~ instruments or money substitutes. Merchants regulate their mutual indebtedness without the transfer of metallic money. The trouble, risk and expense of sending gold or silver from place to place is avoided by making use of paper. It is debts that are bought and sold in Foreign Exchange and their price follows the same laws as other articles of commerce.

The process of converting the money of one country into its equivalent in the money of other countries is carried out through bills of exchange. A bill of exchange is an order by one person addressed to another directing a payment be made to a third person. The bills of exchange are classified as follows:

Inland Bills and Foreign Bills. In the case of Inland Bills the drawer and the drawee live in the same country. In the case of Foreign Bills, the drawer and the drawee live in different countries.

Sight Bill and Long Bill. The former is payable at

sight while the latter is payable after a prescribed period, say, 30 days or 60 days or 90 days.

Trade Bills and Finance Bills. Trade Bills are those drawn against actual shipment of goods. Finance Bills are merely drawn to put oneself in possession of funds when goods are not actually sold.

The largest class of bills that we are concerned with in International Trade are those bills which are orders for payment sometime hence and somewhere else. Says Withers, "Bills of Exchange payable up to six months after sight are the form of currency almost exclusively used in the trade between nation and nations. Not only are the bills of exchange the usual medium of payment in International Trade, but there is the further fact that the London Bill, the bill payable in cash in London, is the great clearing instrument of the international world. London is the centre of the world's dealings in money and goods".

II. The Operation of a Bill of Exchange:-

The principal if not the only reason for our using the Bills of Exchange is to save the expense, risk and trouble incidental to the despatching of gold. Only a small amount of money is used, the greater part of the payment being made through transfer of obligations, that is, through Bills of Exchange. Money is used only to settle the balance after the cancellation of debits and credits. The operation of the

Bill of exchange is as follows:

| America | | England |
|---|---|---|
| A. Exporter. | ↑ ↓ | C. Exporter. |
| B. Importer. | ↓ ↑ | D. Importer. |

C must pay A and B must pay D. Therefore so much money has to be sent forwards and backwards between the two countries. In actual practice however no money is sent, for, A's Bill on C is paid by B; B sends the Bill of Exchange to D who presents it to C and receives payment from him. Thus one bill has paid ~~to~~ two debts: B has paid A and C has paid D. Thus double shipment of money is avoided through the operation of a Bill of Exchange.

III. The Mechanism of Foreign Exchange:-

The mint par or the par of Exchange as between two gold standard countries is the fixed intrinsic value of the currency unit of one country expressed in terms of another. It is value for value of the monetary systems in terms of fine gold between gold using countries. Or as Clare defines it, "The par of Exchange is the rate at which the standard coin of one country is convertible into that of another country according to the terms of their respective mint laws". Thus the par of Exchange between England and America: £ 1 is equal to 4·866 dollars, that is to say one English pound contains the same amount of pure gold as 4·866 of American dollars. The rate of exchange between two countries is said to be at par

when the rate is such that the money of one country can be converted into its exact specie equivalent in the money of another country. The rate is at par whenever the supply of bills as between two countries equals the demand for bills, that is, when the total money value of the exports equals the total money value of imports and thus the total money claims on both sides are equal. Concretely when a bill for £ 1000 is convertible exactly into 4,866 dollars the rate of exchange between England and America will be at Par.

The rate of exchange is very rarely at Par. It may be either below Par or above Par.

Below Par or at a discount. When a bill for 4,866 dollars on New York sells for more than £ 1000, then the exchange is unfavourable to London.

Above Par or at a Premium. When a bill for 4,866 dollars on New York sells for less than £ 1000 the exchange is said to be favourable for England.

In other words, whenever the sovereign buys more of the foreign bills, the exchange has moved in favour of England. In England it is above Par or at a Premium. When the sovereign buys less of the foreign currency, the exchange has moved against England; for England it is below Par or at a discount.

Specie points or gold points: The rise and fall in

the rate of exchange is ordinarily within very narrow limits. These limits are fixed by the cost of transmitting specie or bullion. The question would be whether it is cheaper to transmit coin than to use the bill of exchange - a question which the English merchant or the American merchant has to answer for himself. The two limits - upper and lower - to fluctuations in the rate of exchange are the gold export point and the gold import point. As between England and America, the exchange fluctuations can be thus described:

Gold import point £ 1 = 4.845 dollars
Par = 4.866 "
Gold export point = 4.877 "

The gold import point is the Par value minus the cost of transmitting specie. The gold export point is the Par value plus the cost of transmitting specie. The specie or gold points are those two limits in the rate of exchange at which gold flows from country to country. The rate of exchange may rise, but it does not rise above mint par plus the cost of shipping gold. The rate of exchange may fall but it does not fall below mint par minus the cost of shipping gold.

Let us take two concrete instances: America and England.

a) Suppose exporters in America send goods to a greater value than that of the goods which the importers in America

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have to pay for, in other words, the exports exceed imports. Exporters will offer bills to a greater amount than the importers have occasions to buy. The exporters have an excess of bills on hand. As payment for the excess they can send for specie to England. But this means incurring expenses on packing, insuring expenses, porting, on getting the specie tested and coined into American dollar and loss of interest in the meanwhile. For these reasons the exporter is willing to sell his bill for £ 1000 for a ready sum which is somewhat less than the Par value of 4,866 dollars. How much less will the exporter take for his bill? There is a limit to it and the limit is determined by the expense of getting specie from England - the limit is reached at 4·845 dollars to the pound. He will not sell for less than this amount; rather he would actually import gold.

b) Suppose again the imports into America exceeds the exports from America. Importers need to buy more bill than the exporters can supply. Importers will be willing to pay for the bills more than the par value, that is, more than 4·866 dollars to the pound. But why do they not export gold? Because of the expenses of such a transaction they are prepared to pay as high as 4·885, the difference representing the cost of transmitting specie.

The exchanges which move within more or less prescribed limits, tend to correct themselves automatically. If the supply of bills is less than the demand it is bad for the

importers but it increases the profits of the exporters. Therefore it stimulates exports which in its turn bring about an increase in the supply of bills and restores the exchanges to parity.

If on the other hand the supply of bills exceeds the demand it is bad for the exporters. But it increases the profits of the importers. It therefore stimulates imports and brings about an increased demand for bills. Equilibrium between the exchanges once again is restored.

IV. So far we have considered the exchanges between gold standard countries. Where a country has a silver currency only the rate of exchange between that country and a gold standard country is chiefly determined by the market value of silver in terms of gold. Where countries are on ~~proper~~ paper currency the rates of exchange among them are determined by the purchasing power of their paper currencies, In other words by their respective price levels. How much of the currency of one country is worth in terms of the currency of another country?

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